WILL A RECESSION EVER MATERIALIZE? (WAITING FOR GODOT)

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Introduction

As we discuss the probability of a recession here in Fall 2023, we are reminded of the white paper we wrote in Fall 2021 – "Inflation – Yes or No?" Then, most observers, especially the Fed, were arguing that inflation was transitory. Now, many economists are, one by one, abandoning the notion of a recession, or at least pushing it well into 2024. While our crystal ball is no clearer than anyone else's, we continue to argue for a recession in the U.S. starting sometime between Labor Day (just past) and year end. (We did not expect a recession in 2022 or the first half of 2023.)

While the economy had a stronger first half than expected, we continue to believe a recession is coming within the next 6-12 months. The Fed has hiked rates by 525 basis points, excess savings are shrinking, payroll growth looks set to slow and eventually contract, and global manufacturing and trade are weakening.

Recent History

Global financial markets have oscillated between the "soft landing" and "no landing" economic outcomes. The dominant market narrative argues that the U.S. economy not only has weathered the Fed's rate tightening cycle successfully, but is also set to accelerate. That narrative is supported by the Atlanta Fed's GDPNow model, which is currently forecasting an eye-popping 5.6% annualized growth in Q3. Part of that growth estimate relates to a significant contribution from the change in private inventories, but the model currently projects 4.1% annualized growth in real final sales to domestic purchasers.

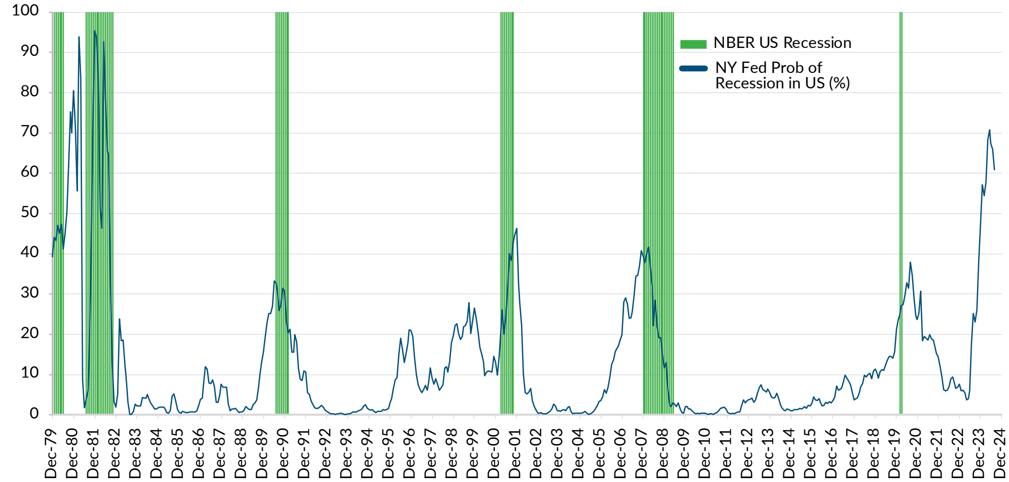
While market participants acknowledge that global ex-U.S. economic growth is faltering, bullish investors would highlight that global growth has not been sufficiently weak to derail the U.S. expansion, and may even aid the Fed and other developed market central banks in achieving their inflation targets. Thus, a strong U.S./weak global economy has been taken by many to be consistent with a soft landing in the U.S., and thus has given some investors a license to increasingly put on pro-risk positions. We acknowledge that stocks have yet to experience a recessionary selloff this year as we predicted would likely be the case. The outsized performance of stocks versus government bonds has been driven very significantly by concentration effects from AI-related stocks.

Having said that, four significant metrics suggest that a recession is on the horizon.

The Evidence

First, the probability of a recession in most models is elevated. As shown in the graph below, there has been a significant spike in the NY Fed's probability of a recession.

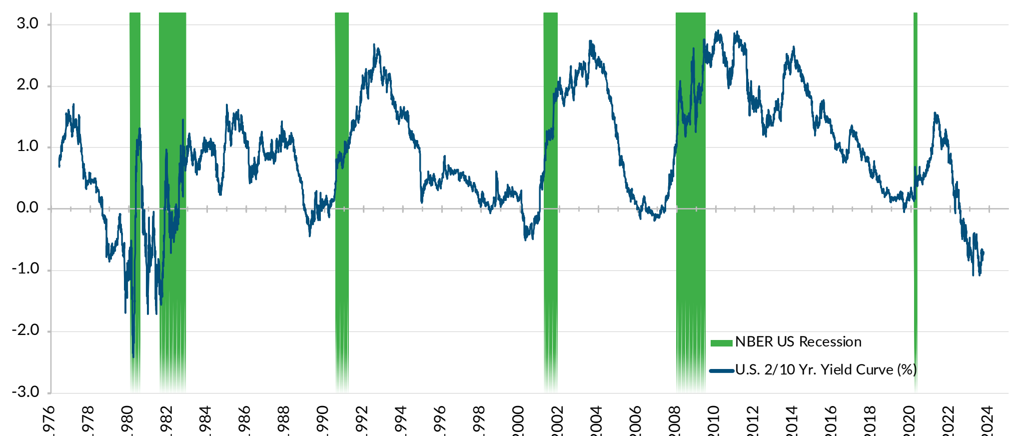
NY Fed Probability of a Recession



Source: Bloomberg. As of 8/31/24.

The second troubling sign is the inverted yield curve. As is obvious from the graph below, inverted yield curves are nearly always followed by recession with long and unpredictable lags.

Inverted Yield Curve

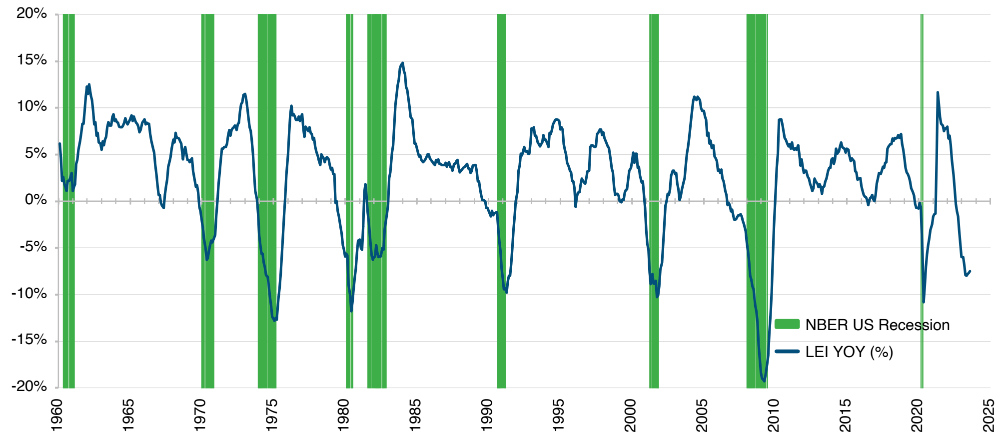


Source: Bloomberg. As of 9/13/23.

The Evidence (cont'd)

Third, leading economic indicators are down 17 months in a row – a record. Their accuracy in predicting a recession (actually, often coincident with recession) is reasonably good. To be fair, many are (appropriately) arguing that these indicators are too goods/ manufacturing focused and not sufficiently services focused, but the historical accuracy of these leading indicators in forecasting a recession is striking.

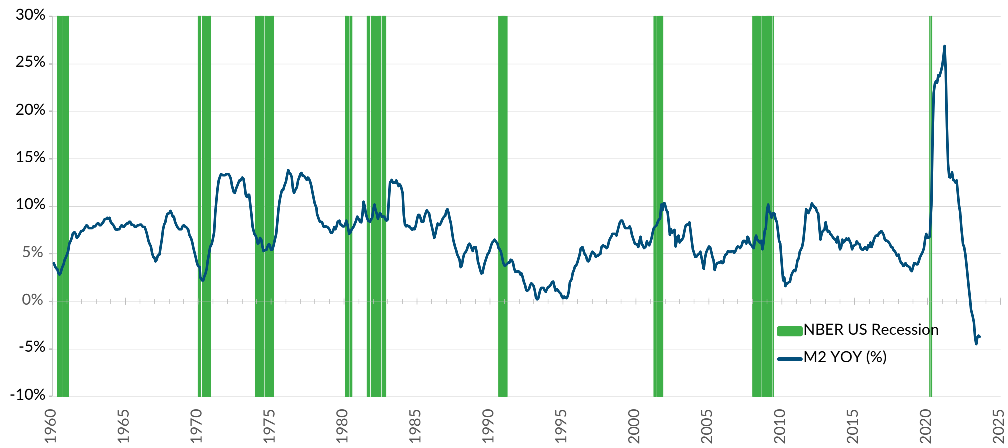
Negative Leading Economic Indicators



Source: Bloomberg. As of 7/31/23.

The final piece of evidence is declining money growth. Granted, money growth and the money supply have been distorted due to the heavy infusion following the onset of Covid. Nevertheless, economies depend on money for sustainable growth.

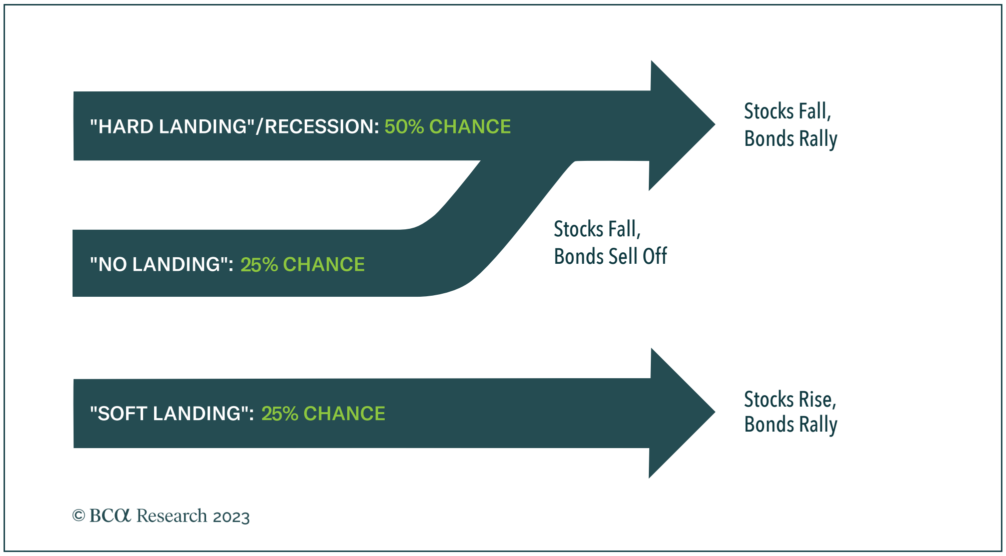
Declining Money Growth



Source: Bloomberg. As of 7/31/23.

Possible Scenarios

The Three Feasible Economic Scenarios, Their Odds, And Their Investment Implications



The graphic above visualizes three feasible economic scenarios for the U.S. and global economies as well as guesses as to current probabilities and the asset allocation implications. Despite this year's rally in equities, our base case scenario continues to be that the U.S. and global economies will slip into recession at some point over the next 6-12 months. The second most likely scenario is one in which the U.S. economy, propelled by an improvement in real wages and larger-than-expected excess household savings, not only avoids recession for a significant period but also experiences above-trend growth – and likely a reacceleration in inflation. The third scenario, the soft-landing outcome, would see inflation come back sustainably to the Fed's 2% target without a recession or a meaningful rise in the unemployment rate. We regard this scenario as the least likely of the three.

The fact that the U.S. economy has not succumbed to recession so far this year has led to much discussion about whether the stance of U.S. monetary policy is, in fact, tight. Some investors who hold that view have interpreted signs that the Fed will soon stop raising interest rates as a bullish development for stocks, based on the expectation that the U.S. economy will continue to grow if the current level of rates is sustained. We believe that the evidence supports the notion that U.S. monetary policy is tight, which supports the perspective that the U.S. economy is on a recessionary path unless the Fed cuts interest rates before the unemployment rate begins to rise. The long and unpredictable lag time between Fed rate increases, yield curve inversion, and money supply contraction cause us to stay put with our recession view.

Possible Scenarios (cont'd)

Tight monetary policy in the U.S. has inevitably led to a recession in past episodes. That means that Fed rate cuts are a prerequisite for the soft-landing scenario to materialize. For rate cuts to occur, the Fed has stated that it must feel confident that inflation is headed back to its 2% target. The June and July inflation data certainly support the soft-landing narrative: core CPI inflation rose at a 1.9% annualized rate in both months. However, we question whether these datapoints are being affected by odd seasonal adjustment patterns.

A bounce-back in short-term measures of inflation may occur over the coming few months. Even if this bounce-back occurs in the context of continued disinflation, it would likely push the Fed more toward the use of 12-month rates of change to assess whether inflation has fallen low enough to justify rate cuts. That would certainly imply later rather than earlier rate cuts, which would likely occur after tight monetary policy has caused the beginning of a recessionary adjustment in the labor market.

While a recession beginning as late as the middle of 2024 would rank on the very long end historically from the perspective of the time lag between tight monetary policy and the onset of recession, it would not be unprecedented. The question of the likely lag between the onset of tight policy and the onset of recession gets to the heart of why the U.S economy has not yet tipped into recession. We did not forecast a recession in the first half of this year, but thought that it would likely begin between Labor Day and year end.

There are two factors that have so far prevented tight monetary policy from causing a significant rise in the U.S. unemployment rate. The first is that the disinflation that has occurred has significantly improved real wage growth, which has boosted the purchasing power of households and raised consumer sentiment. The second is that excess household savings accrued over the course of the pandemic have proven to be larger than we previously expected and have sustained consumer spending in the face of high interest rates. On the real wage front, any further increases in real wages are likely to cause profit margins to fall (which will prompt a rise in the unemployment rate). We suspect that the impact on the U.S. economy of dwindling excess savings will be felt before the aggregate amount reaches zero.

What About China?

China is the one clear case about which concerns over weak growth have negatively impacted global financial markets. In contrast to the U.S., China's economic surprise index fell significantly into negative territory over the past three months, alarming many global investors and raising many questions about why Chinese policymakers are not stimulating more aggressively. China's economic weakness is indeed concerning, especially with respect to China's housing market. Chinese policymakers have grown increasingly reluctant over the past decade to stimulate their economy aggressively in order to confront economic weakness. This reluctance stems from a strong desire to avoid aggravating structural imbalances in the economy and financial system, such as elevated indebtedness, real estate excesses, and financial speculation.

Investment Implications

The U.S. consumer will likely determine whether or not the economy enjoys a "soft landing." In this regard, we are not optimistic. At the high-end, we see the "wealth effect" fading and the virtuous mini-cycle of rising stock prices and upside economic surprises starting to unwind. Further, forward-looking employment indicators are rolling over, "excess savings" is ending, and student loan repayments have just restarted. While nonfarm employment is slowing, the labor market is still holding up. On the surface, this dynamic is positive for the economy and risk assets as it suggest that inflationary pressures are continuing to ease without causing a significant deterioration in the economy. However, the full impact of the Fed's tightening cycle has not yet been transmitted to the economy. We expect the labor market to continue deteriorating and the unemployment rate to rise.

Given the lagged effects of monetary policy, the stickier persistence of inflation and valuation levels, it is difficult to build a bullish narrative. Until a recession is more obvious, we expect the stock market to tread water between S&P 500 4200 and 4600 as it has done since June. Not knowing when a recession might start, but that a slowdown will become more evident, we are using a 4200 S&P 500 target for year end. Should a recession develop and earnings estimates get cut, further downside is likely. Breaking the October 2022 low is unlikely, but possible – unlikely because we expect any recession to be mild due to 1) reasonably good consumer balance sheets, 2) pretty healthy corporate balance sheets, and 3) credit problems on bank balance sheets less than usual. Therefore, breaking that October 2022 low (S&P 500 3574) will hopefully be avoided. Stock selection should focus on earnings predictability, earnings persistence, good and growing cash flow, and reasonable valuations.

Conclusions

1. Outsized equity performance this year has been very significantly driven by concentration effects from AI-related stocks. Stocks have outperformed and financial markets continue to challenge our view that the U.S. economy is on a recessionary path.
2. The available evidence supports the notion that U.S. monetary policy is tight, which argues against the "no-landing" economic scenario. It also underscores that the recessionary clock is indeed ticking unless the monetary policy stance eases soon.
3. The "soft landing" narrative has recently been boosted by the June and July inflation data. However, these readings may have been depressed by odd seasonal adjustments.
4. It is an open debate whether the Fed will meaningfully cut interest rates if inflation falls in line with the Fed's forecasts but the unemployment rate has not yet begun to rise.
5. Improving real wage growth and the prevalence of excess savings are the two factors that have supported U.S. growth and labor demand this year. Both factors are likely to be fleeting, and recent labor market data points to increasing odds that incrementally weaker labor demand will show up in the form of higher unemployment (precipitating a recession).
6. Until we see concrete signs that the soft-landing economic scenario is materializing, we will continue to recommend that investors maintain defensive portfolio positions and prioritize capital preservation over return maximization.
7. Equity selection should focus on earnings predictability, earnings persistence, good and growing cash flow, and reasonable valuations.

Sources: BCA Research, MRB Partners

About Crossmark Global Investments

Crossmark Global Investments is a faith-based firm that creates, manages, and distributes values-based investment strategies that equip financial intermediaries and their clients to go further by aligning their wealth with their passions and convictions. For over 30 years, the firm has delivered uniquely constructed products based on its proprietary, disciplined, and repeatable process. Founded in 1987, the firm is headquartered in Houston, Texas. For more information visit: www.crossmarkglobal.com.

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